# Strategic Plan
# FY2007 and Beyond

## Endowment Fund Investment Board
## Of the State of Idaho

**August 15, 2006**

# Mission of the Endowment Fund Investment Board

Provide professional investment management services to our stakeholders consistent with our constitutional and statutory mandates.

## Goals

*We will provide good investment advice and the tools for implementing that advice. As our clients' individual needs require, we will:*

- Develop a prudent long-term investment strategy
- Select the best portfolio managers and other agents to execute that strategy
- Diligently evaluate performance over time
- Develop an effective spending policy
- Help them fulfill their fiduciary responsibilities and communicate with their stakeholders

*For our employees, we will:*

- Create a work environment which motivates and retains a knowledgeable and professional staff

# Strategic Plan FY2007 and Beyond

# Objectives

The objectives of the Endowment Fund Investment Board are listed separately for each of our clients – the endowment funds, the State Insurance Fund and the Judges' Retirement Fund – and for our employees.

**Goals and Objectives for the Endowment Funds**

- *Develop a prudent long-term investment strategy*
  - Complete an initial asset allocation modeling exercise by January, 2007, taking into account the volatility of the cash flow from land assets
  - Seek new approaches to improve portfolio risk/return characteristics and cost/benefit ratios
- *Select the best portfolio managers and other agents to execute that strategy*
- *Diligently evaluate performance over time*
  - Develop absolute and relative performance standards for the endowment funds by November, 2006. Draft standards are:
    - 4% annual return after inflation
    - Exceed median of peers on a risk-adjusted basis
    - Exceed fund benchmark on a risk-adjusted basis
  - Develop an improved manager monitoring report by June 2007. Incorporate risk measures.
  - Visit each investment manager's head office once every two years
  - Have at least three managers per year meet with the full board to review investment process and performance
- *Develop an effective spending policy*

- By August, 2006, develop a new spending policy concept customized for each of the nine endowments (including the Capitol Permanent Fund). Reflect the limitation of spending only from earnings reserve and allow for quantification of risk of spending shortfalls.
- By March 2007, develop a recommendation on the advisability of making transfers of Earnings Reserves to the Permanent Fund
- Test proposed Spending Policy, get full stakeholder buy-in by August 2007
- Avoid reductions in total endowment distributions
- Long-term, increase distributions to 4% of the value of the endowment funds plus the net cash earnings of the endowment lands while at the same time, growing Earnings Reserves to protect distributions from temporary shortfalls in revenues

- *Help the Land Board fulfill their fiduciary responsibilities and communicate with their stakeholders*
  - Obtain Land Board approval of a new reporting procedure by November 2006 that focuses on measures of governance and process compliance
  - Develop a deeper understanding of cash flow forecasts from the Department of Lands to better measure and monitor the risk of spending shortfalls
  - Provide leadership and analytical support to the Reform Review Task Force to facilitate meaningful improvement in the governance of and return on the state's endowment assets
  - Schedule at least six educational meetings per year for Land Board staff members
  - Build public support for professional and prudent management of endowment assets – Meet at least annually with interested stakeholders

## Goals and Objectives for the State Insurance Fund portfolio

- *Develop a prudent long-term investment strategy*
  - Seek new approaches to improve portfolio risk/return characteristics and cost/benefit ratios
  - Reconfirm, in FY2007, the relationship between the investment portfolio and the SIF's business objectives – ensure we are measuring the right things and looking at the most relevant options for improving the portfolio.
- *Select the best portfolio managers and other agents to execute that strategy*
- *Diligently evaluate performance over time*
  - Meet or exceed the Funds' benchmark
  - Develop an improved manager monitoring report by June 2007. Incorporate risk measures.
  - Visit each investment manager's head office once every two years
- *Help the Manager of the State Insurance Fund fulfill his investment responsibilities and communicate with his stakeholders*

## Goals and Objectives for the Judges' Retirement Fund portfolio

- *Develop a prudent long-term investment strategy*
  - Incorporate the results of an asset/liability study into the Investment Policy within three months of the study's completion
  - Seek new approaches to improve portfolio risk/return characteristics and cost/benefit ratios
- *Select the best portfolio managers and other agents to execute that strategy*
  - Evaluate moving out of ETF's by June 2007
- *Diligently evaluate performance over time*
  - Exceed a 7.5% nominal return

  - Exceed median of peers on a risk-adjusted basis
  - Exceed the Funds’ benchmark by at least 0.5% annually with the same risk as the benchmark
  - Develop an improved manager monitoring report by June 2007.  Incorporate risk measures.
  - Visit each investment manager’s head office once every two years
- *Help the Supreme Court fulfill their fiduciary responsibilities and communicate with their stakeholders*
  - Meet with representatives of the Court quarterly to review performance
  - Assist in reviewing actuarial valuations for the plan

**Goal and objectives for our employees:**

- *Create a work environment which motivates and retains a knowledgeable and professional staff*
  - Build relationships with other key agencies – set up at least two process-sharing meetings annually
  - Hold monthly staff luncheons hosted by the Manager of Investments
  - Train/cross-train the Administrative Assistant, the Investment Officer, and the Senior Financial Specialist in key financial and investment due diligence tasks

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# Key performance measures and benchmarks

(including the rationale for their adoption)

*The efficacy of the Endowment Fund Investment Board's management can best be measured by:*

- *The risk-adjusted performance of the portfolios of each of our three clients*
- *The length of time that the Public School Permanent Fund is below its loss benchmark*
- *The quality of our recommendations to the Land Board regarding the level of distributions*

**Risk/Return Measures & Benchmarks**

These measures will be calculated annually and over multi-year periods

- *Measure:* Absolute return
  - *Endowment funds:* 4% annually after inflation
  - *Judges' Retirement Fund:* 7.75% annually
- *Measure:* Return vs. benchmark
  - *Endowment Funds:* exceed Fund benchmark on a risk-adjusted basis
  - *Judges' Retirement Fund:* exceed Fund benchmark by at least 0.5% annually with the same risk as the benchmark
  - *State Insurance Fund:* meet or exceed the Fund's benchmark
- *Measure:* Return vs. peers
  - *Endowment funds:* Exceed median of peers on a risk-adjusted basis

- o *Judges' Retirement Fund:* Exceed median of peers on a risk-adjusted basis

Rationale for establishing these measures/benchmarks

*There is no single, perfect measure of the performance of an investment portfolio, so multiple performance measurements will be used, customized to the needs of each client and calculated for both annual and multi-year periods.*

*Absolute return:  This is based on the long-term return needs of the client, relative to the level of risk/volatility they are able to endure.  It can be stated in both "nominal" or "real" (after inflation) terms. It is unlikely a portfolio will achieve this return every year, but rather represents the expected return over several market cycles.  Achieving the absolute return target over time is generally more critical for clients like pension plans, whose funding needs (e.g. liabilities) do not vary with markets.*

*Return vs. benchmark:  This is a relative return measure that calculates the value-added of "active" versus "passive" investing.  One can invest in many (but not all) major asset classes in the financial markets thru either index funds or via active management.  Index funds essentially own a representative portion of the whole market and are therefore referred to as "passive" investments because they do not attempt to predict which specific securities in the class will perform best.  "Active" investing attempts to select the assets within a class that will perform better than average.  The efficiency of financial markets makes it challenging to earn active returns in excess of the passive index without taking extra risk.*

*Return vs. peers:  Since a rising tide lifts all boats, comparison to relevant peers, adjusted for risk, allows one to measure whether a fund is doing better or worse than similar participants in the financial markets.  It measures a fund's ability to make investment choices better than average, but* *is difficult to achieve over time because, by definition, half of all funds striving to be above average end up being below average. Also, certain peer group data is only available annually and one can never find a perfectly similar peer group, which limits the value of peer comparison.*

**Public School Endowment Fund Measures & Benchmarks**

- *Measure:* Number of years below cumulative loss benchmark
  - Less than 10 years

<u>Rationale for establishing the measure/benchmark</u>

*The state Constitution requires the state to make up any losses in the Public School Permanent Endowment Fund. Idaho Code specifies that these losses must be made up after ten consecutive years of cumulative losses, as measured at fiscal-year end. Deposits to the fund from the sale of land or extraction of minerals cannot be counted in determining whether the loss benchmark has been met and cash returns (interest and dividends) are not transferred into the permanent fund. Therefore, exceeding the loss benchmark is driven exclusively by the net capital gains of the portfolio.*

*Thru the end of FY2005, the Public School Permanent Fund had been below the loss benchmark for four consecutive years. Unaudited results for the end of FY2006, however, put the Fund back into the cumulative gain column.*

**Public School Permanent Endowment Fund**
**Cummulative Gain(Loss) Calculation**
*(millions of dollars)*

| | Loss Benchmark | Actual Fund Balance | Cummulative Gain (Loss) |
|---|---|---|---|
| Beginning Balance FY2000 | 556.0 | 556.0 | - |
| Deposits - FY01 | 1.7 | | |
| Balance FY2001 | 557.7 | 511.7 | (46.0) |
| Deposits - FY02 | 1.4 | | |
| Balance FY2002 | 559.1 | 441.5 | (117.5) |
| Deposits - FY03 | 2.2 | | |
| Balance FY2003 | 561.3 | 436.2 | (125.1) |
| Deposits - FY04 | 0.8 | | |
| Balance FY2004 | 562.1 | 500.6 | (61.5) |
| Deposits - FY05 | 1.6 | | |
| Balance FY2005 | 563.6 | 537.2 | (26.5) |
| Deposits - FY06 | 1.7 | | |
| Balance FY2006 | 565.4 | 582.4 | 17.0 |

Source: EFIB records

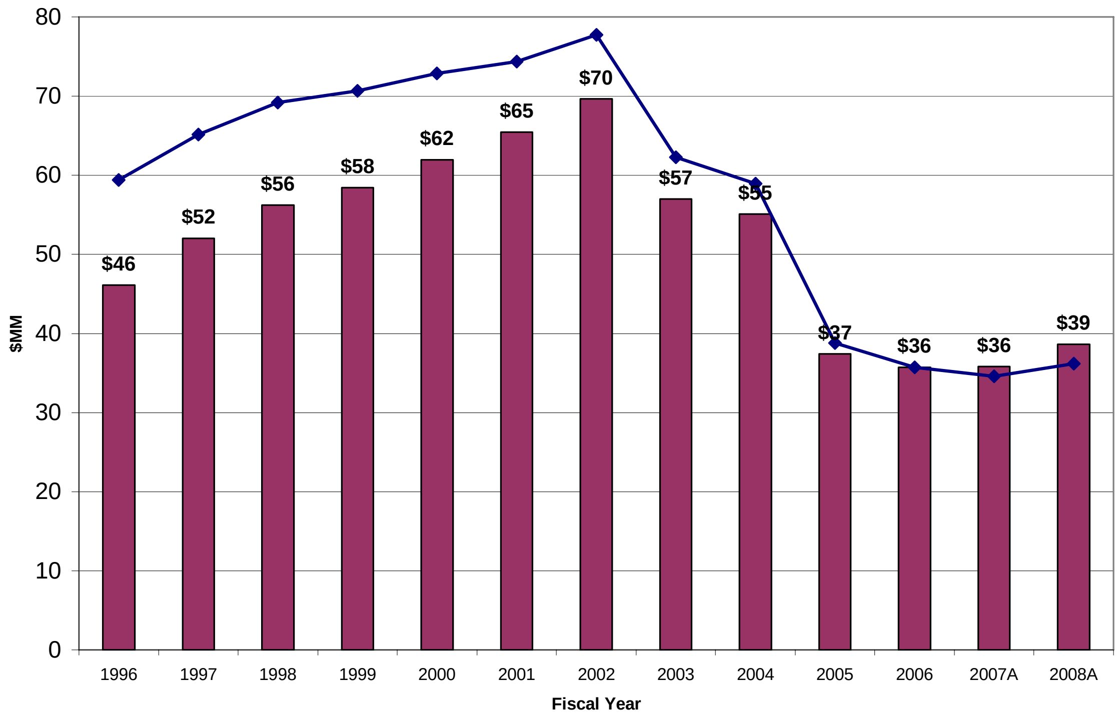
## Endowment Distribution Measures & Benchmarks

- *Measure:* Change in distributions to beneficiaries
  - No reductions in total endowment distributions
  - Within ten years, increase distributions for each beneficiary to 4% of the value of its endowment fund plus the average of the last five years' cash earnings from its endowment lands

Rationale for establishing the measure/benchmark

*The adequacy of the returns of the endowment funds and the efficacy of the Spending Policy are ultimately measured in terms of the distributions to the beneficiaries. While the vision of the state's land and financial endowment assets is to grow distributions over time at a rate in excess of inflation, endowment beneficiaries have experienced declining distributions in almost every year since FY2002 due to the significant bear market in equities in 2000-2002, a high level of distributions in FY2001 and FY2002 relative to the size of* *the reserves, and low timber revenues in FY2003 and FY2005. The drop in distributions in FY2003 was especially traumatic, because it coincided with a significant shortfall in expected General Fund revenues.*

**Total Endowment Distributions To Beneficiaries 1996 to 2008**
**Actual and Inflation-Adjusted (in 2006 $)**
*(Net of General Fund Contribution in 2006 of $4.6MM)*




Source: Legislative Services, EFIB records

*Bringing distributions up to the long-term objective of 4% will take time. Good returns in the last few years have offset the losses of FY2001 and FY2002, but have not yet made up for the impact of inflation. While the endowment funds can currently distribute interest and dividends, they can only distribute capital gains in excess of inflation. At the end of FY2006, the Public School Fund, for example, was approximately 14% behind the amount needed to keep up with inflation (the "Gain Benchmark").*

*Absent transfers from the Earnings Reserve funds, if the fund meets its target of a 4-5% real return, then about 1.5%-2.5% annually will flow to the Permanent funds and refill them to their gain benchmarks in 6-9 years. As each endowment exceeds its inflation-adjusted target, it can then pay out distributions of total gains, including capital gains, rather than only paying out interest and dividends.*

*Earnings Reserve Funds for all endowments were at record levels at the end of FY2006 and are expected to grow further in FY2007, increasing the security of future distributions. The near-term challenge is to grow distributions at a prudent pace which minimizes the potential necessity to reduce distributions in the future.*

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# External factors

### that could significantly affect the achievement of our goals and objectives

*The major outside factors impacting the EFIB are the returns and volatility of the financial markets and the level of timber revenues from endowment lands.*

***I. Financial Markets***

All of the portfolios managed by the Endowment Fund Investment Board are subject to the variability of the financial markets and to the threat of eroding purchasing power due to inflation.

The EFIB attempts to mitigate some of the market risk by investing in diversified portfolios of assets so that the expected variation in the whole portfolio is less than the sum of the variations of each part. The following table demonstrates the sensitivity of each client's portfolio to different asset classes.

## Exposure To Financial Markets By Client

| | *% Of Assets Invested* | | | *Five-Year* | *Annual* |
|---|---|---|---|---|---|
| | *Endowment Funds* | *State Ins. Fund* | *Judges' Fund* | *Expected Return** | *Absolute Risk* |
| **Equities** | | | | | |
| Developed markets | | | | | |
| U.S. | 56% | 14% | 56% | 9.2% | 15% |
| Foreign | 13% | 0% | 13% | 10.0% | 22% |
| Emerging markets | 1% | 0% | 1% | 10.6% | 35% |
| Private equity | 0% | 0% | 0% | 12.0% | 33% |
| High yield debt | 0% | 0% | 0% | 6.8% | 10% |
| **Total Equities** | **70%** | **14%** | **70%** | | |
| **Fixed Income** | | | | | |
| Treasuries/Agencies | | | | | |
| Standard | 9% | 44% | 9% | 4.6% | 6% |
| Inflation-protected | 3% | 9% | 3% | 4.3% | 7% |
| Mortgages (agency) | 5% | 12% | 5% | 5.0% | 6% |
| Mortgages (non-agency) | 10% | 14% | 10% | 5.0% | 6% |
| Corporates, other | 3% | 7% | 3% | 5.2% | 6% |
| **Total Fixed Income** | **30%** | **86%** | **30%** | | |
| Real Estate | 0% | 0% | 0% | 7.6% | 16% |
| Absolute Return | 0% | 0% | 0% | 6.5% | 10% |
| Total | 100% | 100% | 100% | | |
| Duration/Maturity of Fixed Income (years) | 4.6 | 3.9 | 4.6 | | |

* Assumes annual inflation rate of 3.0%

Source: RBC Dain Rauscher, Callan, EFIB analysis

## *II. Cash Flow From Lands*

For the endowment funds, the performance of the land assets is another major external factor that can significantly affect the achievement of our objectives of increasing distributions and avoiding reductions. Viewing all endowment assets, land and financial together, the value of the land is approximately equal to the value of the funds. As a result, about half of the sensitivity of the return on total endowment assets is driven by the return on the lands and about half by the return of the funds.

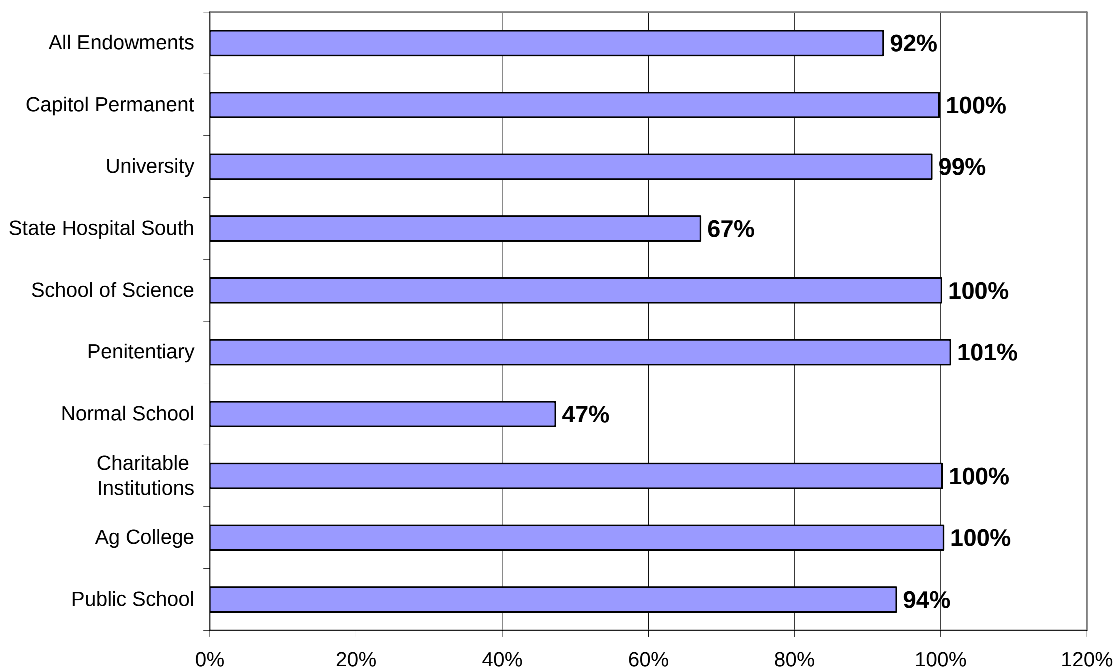
Because the land assets generate a significant portion of each endowment’s total revenue, variations in the total cash available for distribution to endowment beneficiaries is highly subject to the variations in net cash earnings of the endowment lands.  Over the last six fiscal years, these earnings have averaged $43 million annually, with a range of plus or minus $7 million (17%).

| (Millions of $) | ***FY01*** | ***FY02*** | ***FY03*** | ***FY04*** | ***FY05*** | ***FY06*** | ***Average*** |
|---|---|---|---|---|---|---|---|
| Net Lands Revenues | 49 | 42 | 35 | 50 | 38 | 47 | 43 |

Source:  Legislative Services, EFIB analysis

As shown below, 50% to 100% of the net land revenues of each of the endowments come from the sale of timber, so the earnings from their land is very sensitive to the price and volume harvested of timber.

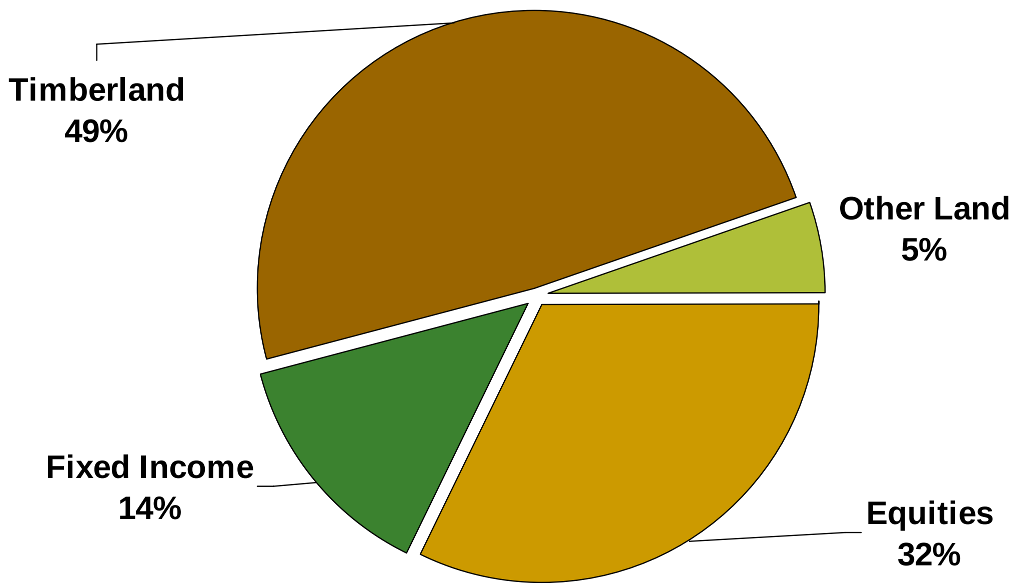
**% Of Earnings Reserve Income From Timber - FY 2005**




Source: Idaho Department of Lands 2005 Annual Report, EFIB analysis

When financial and land assets are combined, the mix of total endowment assets is 49% Timberland, 32% Equities, 14% Fixed Income and 5% other Real Estate (primarily vacation property ground rents).

## Mix of All Endowment Assets
### (Assuming Land value of $1.1 billion)

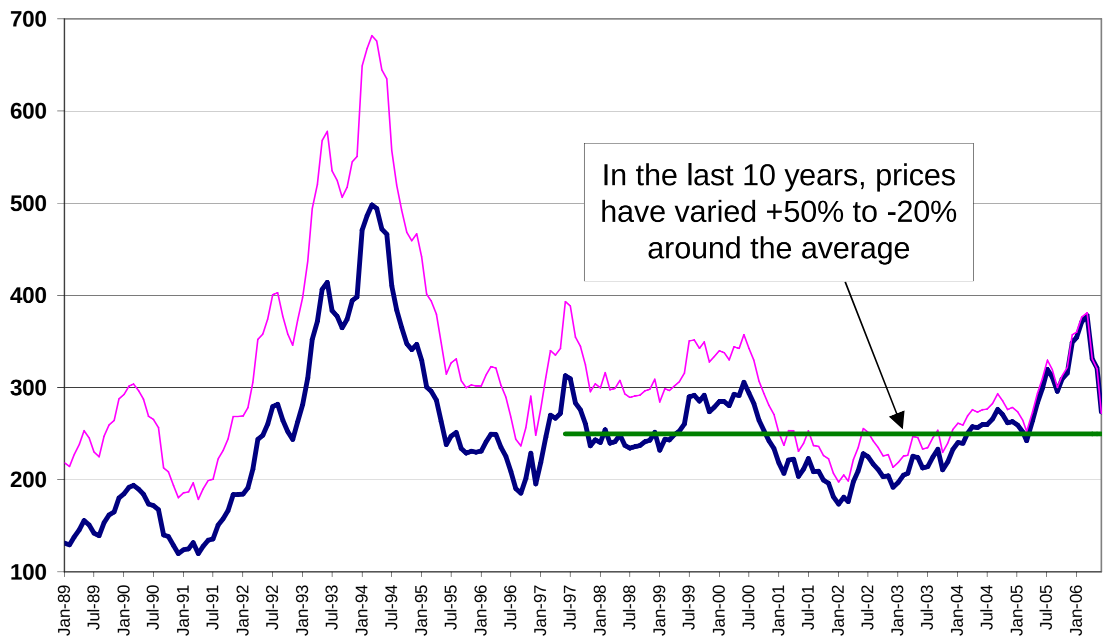



**Total value of all assets = approximately $2.0 billion**

Source: EFIB analysis

Since almost half of endowment earnings come from timber, a major external factor outside the Endowment Fund Investment Board's control is the price of timber and the volume of harvest. The following graph demonstrates the variability of timber prices:

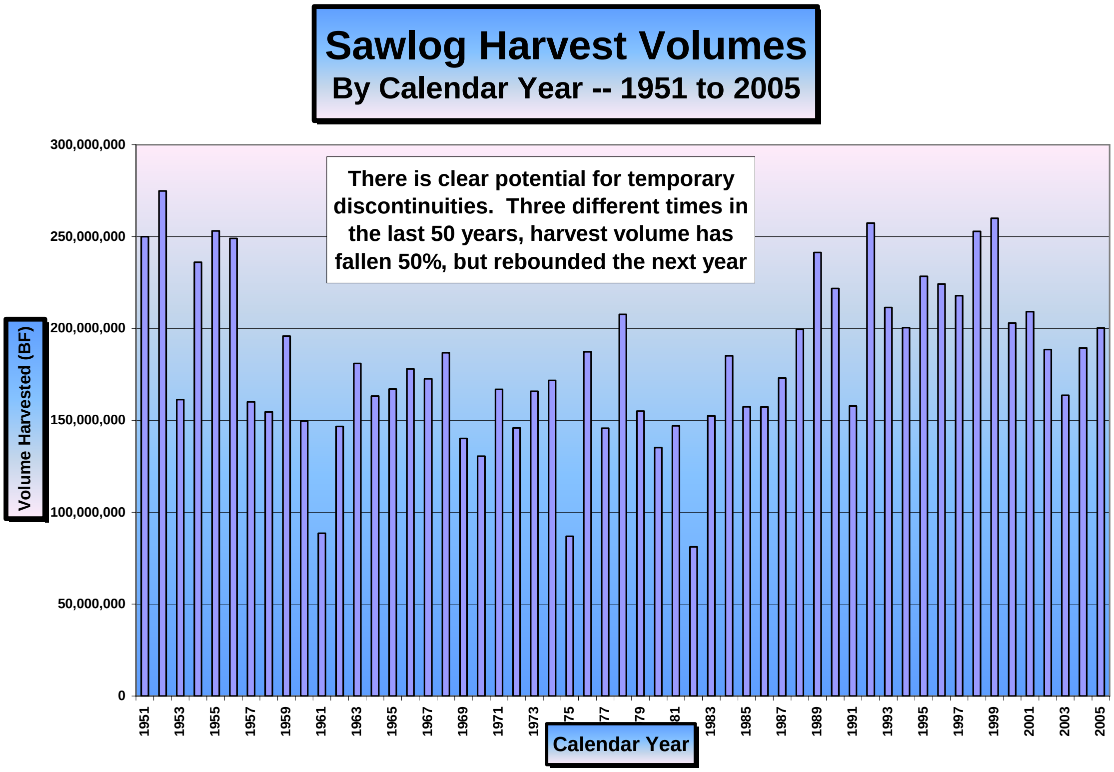
**Idaho Department of Lands Log Price Trends (at Bid)**
**Actual and Inflation Adjusted -- Six Month Rolling Ave**




Source: Idaho Department of Lands, EFIB analysis

Like the stock market, timber prices are essentially unpredictable, so this adds significant risk of error to any cash flow forecast the EFIB might use to develop recommended distribution levels.

The volume of total harvest can also vary from year-to-year.




Source: Department of Lands

Because 70% of the endowment timberlands are for the benefit of public schools, the above graph is a fair representation of the variation in harvest levels on school lands. However, since the land bases of the other eight endowments are significantly smaller (see table below), the variations in their harvest levels from year to year are even larger than the graph above implies and therefore very hard to predict.

| | Acres of Forested Land | | | % of |
|---|---|---|---|---|
| ***Endowment*** | ***Primary*** | ***Secondary*** | ***Total*** | ***Total*** |
| Public Schools | 570,087 | 183,063 | 753,150 | 73% |
| Charitable Institutions | 60,245 | 996 | 61,241 | 6% |
| School of Science | 58,301 | 2,582 | 60,883 | 6% |
| University of Idaho | 41,845 | 991 | 42,836 | 4% |
| Normal School | 40,547 | 2,116 | 42,663 | 4% |
| State Hospital South | 25,753 | 768 | 26,521 | 3% |
| Penitentiary | 26,023 | 56 | 26,079 | 3% |
| Agricultural College | 14,406 | 96 | 14,502 | 1% |
| Capitol | 6,465 | 336 | 6,801 | 1% |
| Total | 843,672 | 191,004 | 1,034,676 | 100% |

Source: Idaho Department of Lands 2005 Annual Report

The variability of land revenues for six of the small endowments over the past six years is two to five times greater than the Public School endowment, as shown below.

| | ***Average Annual Revenues ($ million)*** | ***6-Year Standard Deviation (% of Ave.)*** |
|---|---|---|
| Normal School | 3.3 | 11% |
| Public Schools | 39.7 | 12% |
| Charitable Institutions | 2.8 | 19% |
| State Hospital South | 3.3 | 21% |
| School of Science | 3.4 | 42% |
| University of Idaho | 3.2 | 45% |
| Penitentiary | 1.5 | 64% |
| Agricultural College | 0.6 | 88% |
| Total | 56.5 | 10% |

Source: EFIB analysis. Data is not available for the Capital Permanent Fund.

To address this extreme variability, the Reform Review Task Force is working with the Department of Lands and the EFIB to develop ways to consolidate the land holdings of the eight small endowments into a common ownership – i.e. rather than having 100% ownership of a few acres, each endowment would have a smaller percentage ownership of a larger number of acres.  This would have numerous risk-reducing benefits and help smooth out variability in the level of timber harvests.